

ECONOMIC LOSS AND THE SUPREME COURT OF CANADA: AN ECONOMIC CRITIQUE OF NORSK STEAMSHIP AND BIRD CONSTRUCTION*

Bruce Feldthusen**

John Palmer***

London

The authors employ basic economic analysis of law to criticize two recent decisions in the Supreme Court of Canada. Both decisions break with the common law's traditional aversion to allowing recovery for pure economic loss in negligence. Both put the law in Canada in direct contradiction to the law in England. In each case the authors argue that economic analysis supports the traditional prohibition against recovery, not the new Supreme Court rules. In Winnipeg Condominium Corporation No. 36 v. Bird Construction Co. the court held that a building owner could recover the cost of repairing potentially dangerous defects from the non-privity builder. The authors argue that this new rule is inefficient. The risk had already been allocated in contract by sophisticated commercial parties. The judicial reallocation of this risk will not promote safety as the court assumed it would. In Canadian National Railway Co. v. Norsk Pacific Steamship Co., a divided court allowed the plaintiff to recover for relational economic loss caused by damage to a third party's property. The authors justify the traditional exclusionary rule because relational loss is usually less deserving of legal protection than personal injury or damage to property. Most relational losses are not true social losses. Instead, the plaintiff's loss is another party's gain, a mere transfer. Norsk, however, deals with the rare exception, a relational loss that was a true social loss. Nevertheless, the authors offer two additional reasons to deny the claim. First, the "proximity" rule in the majority judgement does not effectively limit potential plaintiffs. Second, the typical relational loss plaintiff, including the plaintiff in Norsk, is better positioned to insure against the loss.

Les auteurs font appel à des notions de base de l'analyse économique du droit pour critiquer deux décisions récentes de la Cour suprême du Canada. Les deux décisions vont à l'encontre de l'aversion traditionnelle de la common law pour la réparation de la perte purement économique en responsabilité délictuelle. Toutes les deux, elles placent le droit canadien en opposition directe avec le droit anglais. Dans chacune de ces affaires, selon les auteurs, l'analyse économique du droit supporte cette interdiction traditionnelle de réparation, et non les règles posées par la Cour suprême. Dans Winnipeg Condominium Corporation No. 36 c. Bird Construction Co., la Cour a décidé que le propriétaire d'un bâtiment peut obtenir, du constructeur avec lequel il n'a pas de lien contractuel, une indemnité pour le

* The authors would like to thank the Law Foundation of Ontario whose financial assistance enabled us to secure the helpful research assistance of Mr. James Fitch, Law II.

** Bruce Feldthusen, of the Faculty of Law, the University of Western Ontario, London, Ontario.

*** John Palmer, of the Department of Economics, the University of Western Ontario, London, Ontario.

coût de réparation de défauts pouvant être dangereux. Les auteurs plaident que cette nouvelle règle n'est pas efficiente. Il y a déjà eu répartition des risques du contrat selon des règles commerciales sophistiquées. Contrairement à ce que présume la Cour, une nouvelle répartition des risques ne vas pas favoriser la sécurité. Dans *Compagnie des chemins de fer nationaux du Canada c. Norsk Pacific Steamship Co.*, la Cour, sur division, a permis au demandeur d'être indemnisé pour une perte économique incidente résultant de dommages aux biens d'un tiers. Les auteurs justifient l'exclusion traditionnelle de la compensation d'une perte purement économique par le fait que généralement une perte incidente mérite moins la protection du droit que des dommages corporels ou des dommages aux biens. La plupart des pertes incidentes ne sont pas de véritables pertes sociales. La perte du demandeur constitue plutôt le gain d'une autre partie: il n'y a qu'un transfert. L'affaire *Norsk*, cependant, concerne l'exception rare où la perte incidente était une véritable perte sociale. Néanmoins, les auteurs proposent deux motifs additionnels pour rejeter la réclamation. Premièrement, dans l'opinion majoritaire, la règle de la «proximité» en réalité ne restreint pas d'autres demandeurs éventuels. En second lieu, le demandeur dans un cas typique de perte incidente, y compris le demandeur dans *Norsk*, est dans une meilleure position pour s'assurer contre la perte.

I.	Introduction	428
II.	Dangerous Defects: <i>Bird Construction</i>	431
III.	Relational Loss: <i>Norsk Steamship</i>	435
	A. <i>Introduction</i>	435
	B. <i>True Social Loss and Transfers of Wealth</i>	437
	C. <i>Residual Considerations: Justice, Deterrence and Compensation</i>	442
IV.	Conclusion	445

I. Introduction

The economic analysis of law is a well-established area of specialization within the academic disciplines of law and economics. In this article we will explore the extent to which this body of knowledge can be practically employed in a small area of the common law of torts — namely, the recovery of pure economic loss in negligence in two specific situations. Each is illustrated by a recent decision of the Supreme Court of Canada. It is not our intention to communicate exclusively, or even primarily, with experts in economic analysis. On the contrary, our goal is to attempt to demonstrate to all lawyers, regardless of their level of economic expertise, the important role that economic analysis can play in illuminating the law.

First, we will consider the Supreme Court of Canada's decision in *Winnipeg Condominium Corporation No. 36 v. Bird Construction Co.*,¹ which held

¹ [1995] 1 S.C.R. 85 [hereinafter *Bird Construction*].

builders liable to remote purchasers for the cost of repairing dangerous defects in construction. The economic analysis is straight forward here. Then we will consider the more complicated matter of relational economic loss illustrated in *Canadian National Railway Co. v. Norsk Pacific Steamship Co.*²

Typical economic analysis of law is concerned with *allocative efficiency*. All goods and services are scarce. It follows that society ought to allocate these scarce resources to their best uses. *Best* is measured by willingness to pay.³ One can think of markets for goods and services as complicated auctions whereby items are allocated to the highest bidders. Well-functioning markets of this sort generate allocative efficiency by allowing goods and services to move to their most highly valued use. Society is better off by being thus able to get the most out of its scarce resources.

Some economists might claim that allocative efficiency ought to be the main, or even the exclusive, goal of the common law. Some claim that allocative efficiency *is* justice.⁴ No such claims are necessary for present purposes. It is sufficient to say that maximizing the value of our scarce resources is one of a number of goals that the law ought to take into account. Admittedly, there may be areas of law in which efficiency ought to be a relatively minor consideration. However, quite the opposite is true with the two areas of pure economic loss under consideration here. In cases like *Bird Construction* or *Norsk Steamship*, we see little else but allocative efficiency that ought to be of pressing social concern.⁵

² (1992), 91 D.L.R. (44) 289 [hereinafter *Norsk Steamship*].

³ The claim that the best use of a resource may be determined by the willingness of a party to pay for it is probably incomplete and misleading. Willingness to pay varies, at least in part, with ability to pay. If social wealth were redistributed, the "best" allocation of scarce resources under this new wealth distribution would be entirely different from the "best" allocation we would determine given the present distribution of wealth. In the big picture, distributional questions play at least as important a role in shaping social policy as allocative questions. However, the pure economic loss issues we will be discussing in this article have mainly allocative consequences, not distributional effects.

⁴ See for example R.A. Posner, *The Economics of Justice* (Cambridge: Harvard University Press, 1981).

⁵ For instance, La Forest J. quotes B. Feldthusen, *Economic Negligence: The Recovery of Pure Economic Loss*, 2d ed. (Scarborough: Carswell, 1989) at 207-208 with approval in *Norsk Steamship* at 1103-04:

The defendants in this type of case are not typically heinous wrongdoers, but rather individuals and enterprises engaged in common and useful social activity. The same is true of the plaintiffs who are inadvertently harmed by some unfortunate and often inevitable consequence of modern life. Few important moral, social or symbolic issues are involved. Here, if anywhere, the economists' suggestion that the law should devise rules which permit the occasionally incompatible activities of plaintiffs and defendants to continue at the lowest possible total social cost should be taken seriously. This includes rules which encourage *both parties* to take cost-efficient accident prevention measures. And in respect of the unavoidable accidents which remain, it suggests that the loss should be borne by the party who can insure against it at the lowest cost.

As indicated, the economic analysis of law is concerned with the role of law and institutions in promoting allocative efficiency. The methodology is similar to that in other sciences. Just as physics principles are often stated as if objects move through vacuums, the economic analysis of law begins with assumptions that are similarly stylized representations of the real. The first such assumption is that people are rational, and act rationally to maximize their own interests. Lawyers, especially litigation lawyers, may have difficulty with the rational behaviour assumption. The second is known as the zero transaction cost assumption. One assumes that market transactions are cost-free. For example, theoretical analysis begins with the assumption that there are no transaction costs associated with finding out what one wants and who has it, and no costs associated with negotiating and consummating the transaction to obtain what one wants. Lawyers' clients have difficulty accepting this one. The third assumption is that property rights are well-defined. It is nearly impossible for exchanges to occur and for scarce resources to move to their most highly-valued uses if people do not know who owns what or has what legal entitlements.

If these assumptions were true, according to the now famous Coase theorem, law would matter little for allocative efficiency.⁶ Coase used a nuisance case, *Sturges v. Bridgman*, to illustrate his point.⁷ A doctor and a confectioner had adjoining business premises. The noise from the confectioning interfered with the medical practice. Assume that the confectioner valued the premises far more than the doctor. Maybe the premises were uniquely suited for that business, whereas the physician could just as well have practiced down the street. The efficient solution is one that leaves the entitlement to the party who values it most, the confectioner. Suppose, however, that the law of nuisance supported the doctor's claim for an injunction.⁸ The noise could easily be recognized as an unreasonable interference with the physician's use and enjoyment of the premises. Coase explored whether granting the doctor's injunction would impose an allocatively inefficient use of the premises. No, he explained, at least not given the rational behaviour and zero transaction cost assumptions. After the injunction (whereby the court satisfied our third analytical assumption by clarifying who had the property right), the confectioner would simply pay the doctor to move elsewhere.⁹

It is precisely because parties are not always rational, transaction costs are not always negligible, and property rights not always well-defined, that law has an

⁶ R. Coase, "The Problem of Social Cost" (1960) 3 J. L. & Econ. 1.

⁷ (1879), 11 Ch. D. 852.

⁸ Coase himself saw no reason to favour one party over the other. He saw this as a case of two mutually incompatible, but lawful, activities, as a problem of reciprocal harm.

⁹ Assume it is worth \$10,000 to the doctor to stay there (for \$10,001 she can get equally satisfactory premises down the street), but it is worth \$20,000 to the Confectioner to avoid a costly move to the industrial park. The doctor is better off moving than staying for any amount over \$10,000; the confectioner better off staying than moving for any amount less than \$20,000. Rational parties will strike a deal within these parameters. The confectioner will stay and the doctor will move.

important role to play in promoting allocative efficiency. One legal contribution to the efficiency goal is to have the law dictate the efficient outcome when it can. For example, the court may discover that there exists so much animosity between the doctor and the confectioner that it is unlikely the two will bargain in what a disinterested observer would call a rational manner. If the court has no reason to prefer the doctor's claim over the confectioner's, it can simply dismiss the suit. If the court believes the confectioner ought to be held liable in nuisance, it can still promote efficiency by refusing the injunction but awarding damages, say \$15,000, to the doctor.¹⁰ Another legal contribution to efficiency is to develop rules that minimize transaction costs. Much of the law of contracts can be explained on this basis. So too can much of the reluctance to allow recovery for relational economic loss, discussed below.

We now turn to the two areas of pure economic loss discussed recently by the Supreme Court to consider whether a grasp of efficiency analysis might have improved the standard legal analysis.

II. *Dangerous Defects: Bird Construction*

In *Bird Construction*,¹¹ La Forest J. spoke for a unanimous court and stated the issue as follows:

May a general contractor responsible for the construction of a building be held tortiously liable for negligence to a subsequent purchaser of the building, who is not in contractual privity with the contractor, for the cost of repairing defects in the building arising out of negligence in its construction?

The court answered unequivocally "yes". There is no doubt that liability was imposed with the intention of promoting safety. The question of non-dangerous defects was not addressed by the court.

The court's deterrence goal is an ideal candidate for economic analysis. For an economist, tort liability is simply one type of efficiency incentive. The common law of physical damage negligence is entirely congruent with economic deterrence theory. Traditional negligence law extended only to personal injury and property loss, not pure economic loss. There is a sound economic reason for seeking to deter physical damage. Physical damage constitutes net social loss. Something of value is destroyed permanently. The loss can be moved from party to party, from victim to defendant, for example, but it can never be recovered by society. As we shall discuss later, the same is not necessarily true of pure economic loss.

¹⁰ See Calabresi and Melamed, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 Harv. L. Rev. 1089. However, there remains some question as to whether this solution will promote efficient behaviour in the future. It is not clear when potential transactors should be encouraged to rely on courts to set prices.

¹¹ *Supra* footnote 1 at 90. See also B. Feldthusen, "Winnipeg Condominium Corporation No. 36 v. *Bird Construction Co. Ltd.*: Who Needs Contract Anymore?" (1995) 25 Can. Bus. L.J. 143; J.P. Palmer, "Bird: A Confusion Between Property Rules and Liability Rules" (1995) Tort L. Rev. forthcoming.

Negligence law seeks only to deter unreasonable conduct that causes physical harm. Economists would say that we ought to encourage people to take precautions when the cost of avoiding an accident is less than the cost of the accident. The failure to take cost-effective avoidance measures is the failure to take reasonable care. Again, economic theory is quite consistent with standard negligence analysis.¹²

Then there is the question of who ought to be deterred. Often more than one party could reasonably avoid the harm. Economists suggest that the law seek to encourage those who can prevent the loss at the lowest cost. In *Bird Construction*, there is little or nothing pedestrians can do at any reasonable cost to avoid being struck by falling building materials.¹³ Negligence law, correctly from an economic point of view, places liability on the builder or manufacturer, obviously better loss avoiders than potential victims. By “better” we mean that builders or manufacturers would devote fewer scarce social resources to accident prevention than would be employed if we expected each consumer or pedestrian to protect him or herself.

This is a situation where the Coase theorem demonstrates the importance of legal rules. Suppose there were no builder liability for personal injury. If there were no transaction costs whatsoever, all the potential victims would band together and pay the manufacturer to assume liability. This would be far less expensive than taking measures to avoid the injury themselves. This would be allocatively efficient. If transaction costs were substantial, however, (as seems more likely in cases of this sort) such an efficient arrangement will never occur. The law of negligence responds by effectively making the efficient deal on behalf of the pedestrians.¹⁴

Bird Construction, however, is not a physical damage case. It deals with the cost of repairing dangerous defects before an accident occurs. The lynchpin of the decision is the court’s conclusion that for deterrence purposes precisely the same deterrence analysis that pertains to physical damage ought to pertain to the risk of physical damage. This conclusion is incorrect. It is true that we want to discourage unreasonably dangerous construction or unreasonable manufacturing defects. It is not correct that holding builders or manufacturers liable for the cost of removing the danger before an accident occurs is the only or even the most cost-effective decision.

¹² The archetypal version of this costed-harm analysis is, of course, contained in the judgment of Hand Cir.J. in *U.S. v. Carroll Towing Co.* 159 F. (2d) 169 (2nd Cir. 1947). By way of commentary, see for example R. Posner, “A Theory of Negligence” (1972) 1 J. Leg. Studies 29; and White, “Risk-Utility Analysis and the Learned Hand Formula: A Hand that Helps or a Hand that Hides?” (1990) 32 Ariz. L. Rev. 77.

¹³ If, however, pedestrians ignore warning signs and pass under construction sites, a finding of contributory negligence would be consistent with the economic desire to encourage efficient loss avoidance.

¹⁴ It is no coincidence that *Donoghue v. Stevenson*, [1932] A.C. 562 (H.L.) involved a claim by a party who could not purchase warranty protection from anyone in the chain of commerce.

What then is the key difference between the pedestrian's personal injury case just discussed, and the owner's claim to recover the cost of removing the danger in *Bird Construction*? In legal terms, the difference is indicated by the chain of contractual obligations, a *chain to which all the parties are attached*. In economic terms, the difference is that the type of bargain that the pedestrians would make with the builder were it not for the transaction costs has in fact been made by the plaintiff already in *Bird Construction*. Personal injury plaintiffs need the court to impose in tort the efficient arrangement that they would otherwise have bargained in a zero transaction cost world. The plaintiff in *Bird Construction* wants the court to change for its purely private benefit the (presumably efficient) bargain it already had made.

Consider first only an original contract of sale between the builder-owner and the first buyer. Terms of sale will be negotiated. The terms will include an allocation of the risk of a dangerous defect that will require repair. In major commercial transactions, and probably in most other transactions where the risk is great enough to make litigation worthwhile, the parties will actually turn their minds to this particular risk.¹⁵ If nothing is said, under *caveat emptor* the risk will rest with the purchaser. Alternatively, the purchaser could explicitly allocate by contract some or all of that risk to the builder-seller. The allocation of that risk will be reflected in the selling price.

Rational actors would allocate the risk of having to repair dangerous defects to the party who could avoid it at the lowest possible cost. The court in *Bird Construction* assumed that this would be the builder, not some subsequent owner. Presumably, the court thought greater care in construction would be the lowest cost solution. This is not an unreasonable assumption, but nor is it obviously correct. Perhaps builders already take all reasonably cost-effective precautions in order to avoid liability for accidents so there is little else they can do in response to the added risk of repair costs. If so, maybe the owner would be better positioned to make the necessary repairs than the builder should the practically unavoidable risk materialize. Regardless, it seems safe to assume that the parties themselves would be better positioned to make these decisions in contract *ex ante* than would the court to impose them in tort *ex post*.

As far as we can tell from other cases and infer from *Bird Construction* itself, the court would respect the contractual allocation of the risk of repair costs by the parties to the original contract of sale. The court's concern was with subsequent purchasers. Perhaps the court thought that subsequent purchasers, like the pedestrians, were unable to allocate the risk efficiently by contract. If so, the court was incorrect.

In the subsequent contract of resale, the parties can and will negotiate as between themselves who will bear the cost of repairing dangerous defects, exactly as was done in the original contract. If the builder is not the lowest cost-avoider, the fact that the builder is not directly involved in the negotiations is

¹⁵ Professional malpractice liability encourages lawyers to turn their, and their clients', minds to this question.

immaterial. But even if one assumes, as did the court, that the builder is the best cost avoider, there is still a problem with the idea that the court should make the bargain that the parties themselves would have made had they been able to do so. One needs a theory to explain why the parties themselves failed to make that allocation in the first place.

If builders are the best cost avoiders there is every reason to expect that original buyers will contract with them to bear the cost of repairing dangerous defects. There is also every reason to expect that subsequent buyers will want to purchase builder warranties too. We would predict that a market for transferable builder warranties would develop. The marginal transaction costs of adding such a clause to the deal seem insignificant. Maybe such warranties are typical in certain markets. If not, we believe that this is because the parties do not want them. We also believe that in a major building transaction like that in issue in *Bird Construction*, the parties ought to know better what kind of protection they want to buy than does the court.¹⁶ This is the basic Coase theorem again. Because the legal entitlements before *Bird* were well-defined, and because the transactions costs of including warranties in contracts are low, the Coase theorem holds that markets will work to allocate scarce resources efficiently without intervention. If Winnipeg Condominium (and/or its lawyers) failed to specify inclusion of a warranty, we assume that as rational maximizers, they chose to do so. To assume otherwise requires the court to assess what is or would be rational for all parties to all contracts, contradicting the basic precautionary and channelling rationales for contract law.¹⁷

The worst thing about the holding in *Bird Construction* is its impact on builders of previously constructed buildings or manufactured goods. It shifts the risk of repairing dangerous defects away from a party who has already been compensated by not paying for warranty protection, effectively away from a party paid to assume that risk in contract. It shifts the risk to the builder or manufacturer who was not paid to bear it. Obviously, a deterrence goal predicated on the court's theory that dangerous defects are best avoided by more care in construction cannot be achieved in respect of buildings and products constructed before the promulgation of the rule. This aspect of the problem is more one of injustice for the lawyers to consider than misallocation.

Prospectively, there is no reason to believe that safety has been promoted by placing incentives on the parties best able to avoid the loss. Presumably that had already been done by contract. Fortunately, the very contractual chain that makes the decision wrong also renders the error relatively harmless. This is the Coase theorem again. When the liability imposed by the rule in *Bird Construction* is inefficient, the parties will bargain to avoid it. If this is rarely the case, no great

¹⁶ The case might be different, for example, in a market where there existed systemic imbalance in bargaining power between potential defendants and plaintiffs. The market for residential housing might be such a case. Even then courts may not be best positioned to identify or correct the imbalance.

¹⁷ See R. Posner, *Economic Analysis of Law*, 4th ed. (Toronto: Little, Brown & Co., 1992) at 89ff.; L. Fuller, "Consideration and Form" (1941) 41 Col. L. Rev. 799 at 799ff.

harm is done. If this is frequently the case, the decision makes doing business marginally more expensive than it needs to be.

The basic lesson for law from economics here concerns loss allocation by contract. Interestingly, it is a lesson that emerges from both traditional principles of common law¹⁸ and economic analysis of law. The two approaches complement each other. In cases of chain contracts in which each party is linked in the chain, and in which the loss has been allocated by contract, the court ought to identify a problem with contractual allocation before replacing that allocation by a rule of tort. Otherwise, the tort rule is likely to be inefficient. It is also likely to be relatively futile.

III. Relational Loss: *Norsk Steamship*¹⁹

A. Introduction

In this type of pure economic loss case, the defendant negligently damages property belonging to a third party.²⁰ The plaintiff, by virtue of some relationship, typically contractual, that exists between it and the third party, thereby suffers economic loss. For example, in *Norsk Steamship*, the defendant barge negligently collided with a bridge owned by a third party, namely the government Public Works Commission (PWC). The plaintiff CNR was the principle user of the bridge under a contractual arrangement with PWC. The defendant admitted liability to PWC for the cost of repair under ordinary negligence principles. CNR sued for its relational loss — essentially the cost of rerouting its trains.

In a most peculiar decision, the court held for the plaintiff. One judge of the seven, Stevenson J., held for the plaintiff on the ground that the defendant actually knew about the CNR's interest. This "notorious plaintiff" theory was rejected by all six other judges. Economists would similarly reject this as an irrelevant distinction. McLachlan J., speaking for herself and two others also held for the plaintiff on the ground that there existed a sufficient relationship of "proximity" between the parties.

There was a number of factors that might be referred to as indicators of "proximity" that could distinguish the CNR from other possible claimants. For example, the bridge joined CNR tracks, CNR had a maintenance agreement with PWC., and CNR was by far the main user. None of these distinctions has any direct economic relevance either. Nor did La Forest J., who gave the dissenting judgement on behalf of himself and two others, think they were of any legal relevance. His decision was explicitly economic, and some of his economic premises will be considered below.

¹⁸ For example, see the judgment of Ritchie J., speaking for the majority of the Supreme Court of Canada in *Rivtow Marine v. Washington Iron Works*, [1974] S.C.R. 1189.

¹⁹ *Supra* footnote 2.

²⁰ Claims for relational loss consequent on personal injury to a third party are not considered.

The common law has always recognized two basic economic problems with allowing recovery for relational loss under the same principles that govern recovery for physical damage. First, and more prominent in the case law, there is the “floodgates” or “too many plaintiffs” problem. Second, there is the “too much liability” or “liability out of proportion to fault” problem. Economic analysis can both validate and clarify these concerns. Less prominent in the case law, although explicit in the judgements in *Norsk Steamship* itself, is a third consideration. This is a consideration of relative insurability; that is, which party is typically better able to insure against the loss.

The courts have always been aware that there are too many potential plaintiffs who may suffer foreseeable economic loss whenever property damage to a third party occurs. The system could not reasonably cope with the exponential increase in tort claims that would occur if *Donoghue v. Stevenson*²¹ applied. The history of the relational loss case law is one of the judicial search for the elusive formula that would respond to this problem while still allowing “deserving” claims. An economist would say that the social gains from basic negligence liability (more on that below) would be more than offset by the administrative costs of using the courts to transfer the loss from multiple plaintiffs to a single defendant each time property damage was negligently inflicted. Put otherwise, the value of social resources may be maximized by leaving the responsibility for relational losses with potential plaintiffs themselves. Where the common law may have gone astray is in emphasizing this concern above all others. After all, relational loss ought not to be recoverable *only* because the class of potential plaintiffs can be effectively limited. There are at least two other economic arguments against recovery.

The first turns on the distinction between “social loss” and mere “transfers of wealth”. Here we consider the amount of liability, not the number of claimants. Initially, an objection to excessive liability being placed on one defendant might seem misplaced. No such concern arises in cases of physical damage. Liability for momentarily inadvertent conduct that leads to serious personal injury is usually grossly out of proportion to fault. Economic analysis can remind us that proportioning liability to wrong is the province of the criminal law, not tort. Economists would posit the goal of tort liability in deterrence terms. Consistent with the allocative goal discussed earlier, they would want potential defendants to anticipate liability equal to the true social cost of their conduct and to act or refrain from acting accordingly. The question would then be whether relational economic losses are or are not “true social costs”.²² We will argue that it is too expensive and uncertain to draw this distinction on a case-by-case basis. Most relational loss claims turn out not to be claims that correspond to true social loss.

²¹ *Supra* footnote 13.

²² W. Bishop, “Economic Loss in Tort” (1982) 2 Oxford J. Leg. Stud. 1; see also M. Rizzo, “The Economic Loss Problem: A Comment on Bishop” *ibid.* at 197 and M. Rizzo, “A Theory of Economic Loss in the Law of Torts” (1982) 11 J. Leg. Stud. 281. Bishop responds to Rizzo’s critique in “Economic Loss: A Reply to Professor Rizzo” (1982) 2 Oxford J. Leg. Stud. 207.

Only one or two categories of cases can be identified as typical social loss claims, and worthy of legal protection on that ground.

Another economic concern with relational loss revolves around what we will call the insurance goal. Major losses that cause economic disruptions — bankruptcy or family crises, for example — are also socially wasteful. Our laws ought to encourage efficient protection against such extreme disruptions. Economic analysis might say that losses should be directed towards to the best insurer. We will show that claimants themselves, not negligent defendants, are usually the best insurers against relational loss.

It is our opinion that the economic case against allowing recovery for relational loss can be made on either the “too many plaintiffs” or the “no social loss” ground alone. That is, there is no justification for allowing recovery for relational losses that are not social losses, even if one could effectively limit the number of potential plaintiffs. Equally, there is no justification for allowing recovery for relational losses that do constitute true social losses when the number of potential plaintiffs can not be constrained. The case against recovery is overwhelming when the claim suffers from both shortcomings. A case, although not necessarily a compelling case, can only be made for recovery for relational losses that are true social losses where potential plaintiffs can be limited. Thus far, there have been few recognizable categories of cases that meet both conditions for recovery. In such cases, it still remains to consider which party is the better insurer.

As much as possible, we will use the Supreme Court’s decision in *Norsk Steamship* to illustrate our points. In our opinion, the majority was incorrect to allow the plaintiff’s relational loss claim because neither of the judgements adequately limited the class of potential plaintiffs. Stevenson J.’s “notorious plaintiff” test has no economic basis whatsoever. Nor does McLachlan J.’s “proximity” test. Moreover, being completely uncertain in application, the “proximity” approach imposes extra decision-making costs on potential and actual litigants. We would argue that *Norsk Steamship* was wrongly decided for that reason alone. There is nothing more that economic analysis can add to that argument. However, some may find that “proximity” does constitute a meaningful and clear *ex ante* limit to the number of potential plaintiffs. Others may not regard the limiting problem as sufficient justification for refusing the claim. We will therefore turn our attention to the other issues on which the economic analysis may shed some light.

B. True Social Loss and Transfers of Wealth

Suppose that the defendant negligently knocks over a hydro pole and puts a grocery store out of business one Saturday. The physical damage to the pole is a net social loss. Something that once existed has been destroyed permanently. Ordinarily, the proper measure of damages is the cost of replacing it. If the pole’s commercial value were less than the cost of replacement, that would be the accurate measure of the social loss, and that is what the law would award.

If the pole had salvage value, that should be deducted to determine the net loss. Are the store's lost profits a net social loss? Certainly not to the extent of the average Saturday sales. Some customers will simply put off shopping for a day or two. Some will go to another branch of the same chain. The common law would not recognize damage in such cases. But suppose the plaintiff could prove that all its customers had shopped instead the same day at its competitor across the road. There will be some social loss in such a case. The unlucky plaintiff may have had to keep some staff on.²³ The lucky competitor may have had to call in extra staff. The net effect would be the employment of more than an efficient amount of labour for the day by these stores. It is this misallocation of labour (and other similar misallocations) that constitutes the social cost. But the bulk of the plaintiff's lost profit claim is not a social loss at all, but rather a transfer of wealth from the plaintiff to the lucky competitor.²⁴

Economists might refer to this as a *mere* transfer of wealth. The word *mere* would not be the first to come to the plaintiff's mind. Judges who look at things from the plaintiff's position might be tempted to agree, especially given that the defendant was negligent. But they would succumb at the considerable social cost of over-deterrence.

Assume that the defendant is a heavy machinery operator looking at a foreseeable average daily risk of property damage of \$100. There is also an additional risk of relational loss claims of \$100, \$25 of which is true social loss and \$75 of which is transferred loss. All negligent accidents can be avoided by hiring a lookout at \$150/day. In this example, society would be better off to experience the accident than to encourage the operator to hire the lookout to prevent it. The total social cost of the accident is \$125 (\$100 + \$25) which is less than the cost of preventing it, \$150. In a jurisdiction with no tort recovery for relational loss, the rational operator would not hire the lookout. However, if the law allowed recovery for relational loss, the operator would hire the lookout for \$150 to avoid paying damages, damages now increased to \$200. Society would then be wasting \$25/day preventing the accident by spending \$150 on a \$125 accident. This is too much deterrence. The cost of operating heavy machinery is \$25 greater than necessary.

If we act upon our sympathy for relational plaintiffs by allowing them to recover, this will generally be accompanied by higher prices for everything we buy and use, and less of things we could otherwise afford. True, the relational loss claimants have a \$100 private loss, \$25 of which also represents a true social loss. Later we will consider whether potential relational loss plaintiffs might be protected more efficiently than through tort law.²⁵

²³ For an intuitive recognition of this see *Dominion Tape of Canada Ltd. v. L.R. McDonald & Sons Ltd.*, [1971] 3 O.R. 627 [hereinafter *Dominion Tape*], approved by Wilson J. in *Kamloops (City) v. Nielsen*, [1984] 2 S.C.R. 2.

²⁴ Another social cost is that some shoppers end up shopping in stores that were not their first choice. Of course the task of quantifying these losses and the cost of compensating each shopper make liability for these losses practically impossible.

²⁵ See Part (C) below.

What this example illustrates more generally is that many relational economic losses are different in kind from claims for physical damage; many constitute private but not social losses. To allow recovery for purely private transfer losses in effect taxes and discourages useful social activity to everyone's detriment. Ideally, from an efficient deterrence perspective, the law ought to allow only claims for relational economic losses that are true social losses. Keep in mind, however, that even if this were feasible, the "too many plaintiffs" administrative cost problem would remain.

The astute reader may have noticed a significant omission in the analysis thus far. What about *consequential* economic losses, losses that *are* routinely recoverable in negligence? For example, suppose the power company that owns the damaged pole wished to claim for its lost profit on the sale of electricity. That also is a mere transfer of wealth, for exactly the same reason that we said the store's lost profits were not social losses. It follows that our suggestion that the law of negligence ought not to protect merely private transfer losses should, as a matter of logical symmetry, apply to consequential loss as well. In fact, the difficulty of drawing rational distinctions between pure and consequential loss has continually influenced judges against adopting a general exclusionary rule for relational loss. In a perfect world, we would argue that only social loss, whether consequential or pure, ought to be recoverable. Maybe if economic analysis had been influential at the time the rules governing recovery for consequential loss developed, an exclusionary rule for consequential loss might have been adopted. For now, we can offer three justifications for treating pure economic transfer loss differently from consequential transfer loss. First, it is better to treat at least one claim properly than to treat two equally incorrectly. Second, the administrative costs of allowing the physical damage plaintiff to add a claim for consequential loss will be less than the administrative costs of allowing additional claimants. Third, the over compensation for consequential loss may roughly balance the under compensation for pure social loss, and thus provide a more accurate deterrence incentive.

Assuming that the law wanted to restrict recovery to relational losses that did constitute true social losses, the next issue is whether there is any practical way of doing so. It would be difficult and expensive for courts to determine whether, and if so to what extent, any particular claim for relational loss constitutes a claim for social loss. An economist might suggest that the court consider whether close substitutes for losses claimed were available. Loblaw's seems to be a close substitute for the A&P a block away. Is CPR a close substitute for CNR? Is trucking for air freight? How close is close enough? Even assuming the substitute is close enough to suggest little social loss, can the substitute accommodate the increased business without substantial increased cost? If not, there is a social cost, but one that can only be quantified expensively with technical evidence available from competitors who are not parties to the litigation. Those social losses would be borne by the substitutes who are quite happy to incur them in return for acquiring the new profitable business. In amount, they are much smaller, and quite unrelated to the relational plaintiffs' loss.

It follows that the economic analysis does not support the case-by-case “proximity” approach adopted by McLachlan J. in *Norsk Steamship*. The economist would have the same objection to the inherent uncertainty in the term “proximity” as would the lawyer. The economist would also note that none of the factors said to distinguish the plaintiff in *Norsk Steamship* from other relational loss plaintiffs is indicative of a claim for true social loss. The cost of refining McLachlan J.’s approach to one that seeks to identify and quantify true social losses would greatly exceed the benefits of doing so. Beyond all that, the “too many claims” problem would remain.

In *Norsk Steamship*, La Forest J. endorsed an approach which precludes recovery for most relational loss, but allows certain types of relational claims that can be distinguished on a principled basis. The benefit of this type of approach is that it could lead to a more accurate estimate of the true social cost of negligence than one such as the English that precludes altogether recovery for virtually any relational loss. Against this must be balanced the costs of identifying the exceptional categories in each case, and the increased costs associated with processing more claims in each case of property damage.

Many jurisdictions allow recovery for relational loss in a category of cases commonly known as cases of “transferred loss”. These are cases where the third party allocates the risk of damage to its property to the plaintiff by contract.²⁶ A common law analysis could support recovery on the ground that this was really damage to property, albeit damage transferred before the accident by contract to the plaintiff. For the same reason, if one assumes such cases are easily recognized,²⁷ the economist could support recovery because this is an obvious case of true social loss. In further support of recovery, this is an exception that does not impose additional administrative costs. Almost always, the plaintiff claims instead of, not in addition to, the property owner. Significantly, this is the only category of case that the authors have been able to identify as meeting both the conditions we posited for as necessary for recovery: social loss and limited potential claimants.

A variant of this situation may arise with damage to public resources if legislation does not exist to allow the state to impose liability. For example, in

²⁶ B. Feldthusen, *Economic Negligence: The Recovery of Pure Economic Loss*, 3d ed. (Scarborough: Carswell, 1994) at 253-59. For example, in *Cue v. Breland*, 29 So. 850 (Miss. 1901) the third party bridge owner contracted with the plaintiff for the plaintiff to bear the cost of repairing the bridge should it be damaged. In thinking about this further, Feldthusen would now include in this category the “joint average contribution” exception to the exclusionary rule that he had previously (and now believes erroneously) classified as a “joint venture” exception in *Economic Negligence*. A “joint average contribution” pertains to expenditures incurred to repair the ship that are assigned to the cargo owner not by contract, but by the law of admiralty. See also Bishop, *supra* footnote 22 at 25. Note the unfortunate quirk in terminology whereby the “transferred loss” category indicates exactly the opposite of losses that are mere “transfers of wealth”.

²⁷ With any exception to a bright line rule comes the difficulty of categorization. For example, is the classic relational loss case of *Cattle v. Stockton Waterworks Co.*, [1874-80] All E.R. Rep. 220 (Q.B.) a transferred loss case? See Feldthusen, *supra* footnote 5 at 258-9 and Bishop, *ibid.* at 21-22.

Union Oil Co. v. Oppen,²⁸ commercial fishermen were allowed to recover for damage to their enterprise after the defendant caused an offshore oil spill. Clearly the oil spill caused social loss, and clearly deterrence incentives require the defendant to be held liable to *someone*. Nevertheless, the *Union Oil* solution is not ideal. The fishing profits are not a measure of the social loss. Moreover, the “special damage” test used to distinguish the plaintiffs from other relational loss claimants who did not recover is highly artificial and unsatisfactory. While we can applaud the rough justice in the case, we do not see *Union Oil* as leading to the development of a principled exception to the exclusionary rule.

The “joint venture” cases are another category of exceptional cases that would presumably be recognized by *La Forest J.*. These pertain to loss of use claims by plaintiffs who share the same use venture in the damaged property as does the owner.²⁹ Two such sorts of claims have become well-established: claims by ship charterers, and claims by fishermen who participate in “share-the-catch” agreements with the owner. The gist of the common law’s support for recovery is the idea that the relational loss claim in such situations is virtually indistinguishable from the owner’s loss of use claim. For the reasons given earlier, this may be true, and disturbing, but it is not a satisfactory solution to the problems of either true social loss or transaction costs.

Interestingly, ship charterers do not really participate in a joint venture at all. The owner has a different use (chartering) from the charterer (transport). The economic objection to a charterer’s claim is that the loss of use profits will not typically be a true social loss.³⁰ There are usually available many close substitutes for any particular vessel. In addition, the chartering exception adds a second potential plaintiff to each accident involving a chartered ship. Economic analysis does not support the charter exception. It fails on two grounds.

The fishing cases are a little different in that there is a true joint venture. However, the economic case for recovery is no stronger. Fish not caught today are different from fish destroyed.³¹ They still exist, presumably to be caught another day. The social loss to consumers from substituting frozen fish, shellfish, or chicken is considerably less than the full value of the lost catch, and it is borne by consumers, not the plaintiffs. We do not think that the joint fishing venture exception can be supported on the ground of deterring true social loss either. The justifications for this exception are to be found elsewhere. One is the desire to protect a particularly vulnerable class of potential plaintiffs.

²⁸ 501 F. 2d 558 (9th Cir. 1974) [hereinafter *Union Oil*].

²⁹ Feldthusen, *supra* footnote 5 at 244-53.

³⁰ We recognize that being forced to charter a different ship, being delayed, undertaking additional negotiation costs, may all involve social losses in the purest sense of either (a) reducing the utility of the consumers by some infinitely immeasurable amount or (b) increasing their actual transactions costs. In both cases, the adjudication costs of measuring and awarding damages would be insurmountably high relative to the actual social losses, and so it is efficient to deny the claims. We also admit that the owner’s consequential loss of a chartering fee constitutes a transfer, not a true social loss. See our discussion of consequential loss *infra*.

³¹ See *Union Oil*, *supra* footnote 28.

Another is to avoid the apparent incongruity of allowing the owner to recover his or her share of precisely the same loss that would be denied his partners in the joint enterprise.

The claim in *Norsk Steamship* was not one for transferred loss. PWC retained the risk of damage to the bridge itself, a risk for which it was compensated by the defendant. Nor were PWC and CNR engaged in the same joint venture. However, *Norsk Steamship* may illustrate a different category of relational claim for true social loss. It appears that the claim was solely in relation to the cost of rerouting the trains, “the additional costs of operation, no claim being made for any lost freight service”.³² More generally, this category might be described to include claims for the increased cost of honouring existing contractual commitments. Or broader still, it might be defined as one dealing with claims for reliance (but not expectation) loss based on negligent interference with contractual relations.³³ Provided CNR’s costs were less than the cost of breach (damages for non-performance³⁴), and less than the cost of hiring a competitor to complete the contracts, CNR’s claim would appear to be an accurate measure of the true social loss. Note that this is an entirely different line of argument than that accepted by the four judges who held for CNR.

Like the transferred loss category, the contractual reliance loss claims do signify true social loss. In fact, this is the only significant category of social relational loss other than transferred loss that we have been able to identify. Unlike the transferred loss category, however, this category does nothing to address the “too many plaintiffs” problem. In *Norsk Steamship* itself, there were three other railways who used the bridge. The reasons the majority judges used to distinguish CNR alone as a worthy claimant have no economic basis, nor, many would argue, any basis in law either. In our view, this is a sufficient reason to deny the claim. In the next section, we will assume for the sake of analysis that some rational distinction between CNR and other potential claimants was effectively drawn, and can be effectively drawn in future. We then consider a further economic objection to allowing recovery in *Norsk Steamship*.

C. *Residual Considerations: Justice, Deterrence and Compensation*

In this section, we continue to examine *Norsk Steamship*, based on two assumptions. First, as we have demonstrated above, we agree that the loss claimed for rerouting the trains was true social loss. Second, we assume for the sake of analysis that the court identified a rule that will enable us to limit the number of potential relational loss claimants. We do not accept that the court did

³² (1989), 49 C.C.L.T. 1 at 2 (F.T.D.)

³³ See *Dominion Tape*, *supra* footnote 23.

³⁴ Society would be better off to have the goods shipped by other companies if that were less costly. CNR could be compensated for the cost of hiring the substitutes if liability were thought appropriate.

in fact do so in *Norsk Steamship*. We now examine whether, given that both these conditions are satisfied, there are any other relevant economic considerations.

First, there is the argument that it is only just that one who has by his own fault injured another ought to be held liable to put things right. This is probably what La Forest J. referred to as the argument from morality and what McLachlan J. suggested ought to be decisive when the arguments based on efficiency alone were uncertain. We will not enter into any economic analyses of justice here, and leave this line of argument for lawyers and philosophers. There is, however, one contribution that economics can make to the legal definition of "fault". In an excellent article, Siebrasse has convincingly demonstrated what many lawyers know intuitively—there is a systemic tendency to define as "negligent" conduct that is not at all morally blameworthy.³⁵ If so, the justice argument may be overstated in all of negligence law, not only in the relational loss area.

Second, there is the fundamental economic concern with deterrence. Recall that economic analysis endorses liability for social loss as an incentive to prevent allocative inefficiency, the waste of scarce resources. If barge captains were not subject to tort liability for anything, even for physical damage, they would still exercise some care in navigation. They would not want to risk their own safety, or damage their own vessels or cargo. The prospect of liability to other property owners provides an additional, and not insignificant, incentive to take care. The question is whether the defendant in *Norsk Steamship* would have or could have reasonably done anything more to prevent the accident if it had known that it would have been held liable for the relational losses of the CNR. Is better navigational equipment available? Is there anything more they could have efficiently done to reduce the chances of human error? It costs money to shift relational losses. Would this be an efficient investment in safety? La Forest J. may have overstated the case to suggest that liability for physical harm was "largely sufficient", but he was on the right track.³⁶ The deterrence argument for moving from no liability to liability for physical damage is usually stronger than the deterrence argument for adding additional liability for relational losses. This is another economic reason to be less concerned with liability for relational losses than with physical damage.³⁷

Third, independent of the accident deterrence goal, there is the matter of insurance. Catastrophic losses disrupt ordinary economic activity, and that generates social waste. Ideally, people and enterprises should make efficient plans to cope with the prospect of such losses. Commercial insurance is one obvious way of doing so. With first party insurance, potential victims insure themselves against their own anticipated losses. With liability insurance, potential tortfeasors insure themselves against liability they may incur. If for

³⁵ N. Siebrasse, "Economic Analysis of Economic Loss in the Supreme Court of Canada: Fault, Deterrence, and Channelling of Losses in *CNR v. Norsk Pacific Steamship Co.*" (1994) 20 Queen's U.L.J. 1 at 9-18.

³⁶ *Supra* footnote 2 at 349.

³⁷ *Ibid.* La Forest J. at 352. Siebrasse, *ibid.* would appear to concur with this, albeit with reservations.

no other reason than the loss-shifting costs associated with a liability regime, first party insurance is a significantly less expensive way to insure against loss than liability insurance.³⁸ To the extent that insurance concerns are prominent, we should discourage liability for relational loss and encourage potential victims to buy their own cover. First party insurance for the type of loss claimed by CNR is available.³⁹ CNR itself probably chose to self-insure rather than to purchase private first party cover. This is simply a more efficient solution for a large enterprise like CNR. It does not affect the argument for leaving CNR to deal with the loss rather than have society incur the extra costs of shifting it into the more expensive third party liability pool. Siebrasse puts it as follows: “. . . for firms which now carry first party business interruption insurance, for large self-insured firms, and for firms in the service industry, the extension of tort recovery and the concomitant switch to liability insurance is undoubtedly wasteful”.⁴⁰ In contrast, the insurance rationale may be the very best argument in favour of the “joint fishing venture” exception discussed earlier.

Finally, many potential relational loss claimants can protect themselves by providing in their contracts that the property owner bear the risk of loss. For example, CNR might have contracted with PWC for PWC to bear the extra costs of rerouting their trains if PWC’s bridge was damaged. In that event, the loss which would be relational if borne by CNR would be consequential (and recoverable) if borne by PWC. This is sometimes referred to as “channelling” the loss, although there are other variants of the channelling option that need not concern us here. *La Forest J.* seemed to hold the fact that CNR had failed to channel its loss was a reason to deny the claim.⁴¹ *McLachlan J.*, noting correctly that it is unlikely that public enterprises like PWC will enter into channelling contracts, seemed to see this as a reason to favour CNR’s recovery. We do not agree with either position.

On the surface, channelling has the advantage of reducing transaction costs because the losses will be claimed by only one party, the third party who is probably already claiming for physical damage. Siebrasse suggests that even these savings may not materialize.⁴² Moreover, this is merely a device whereby someone’s relational loss is “artificially” transformed into someone’s recoverable consequential loss by contract. Two parties, PWC and CNR, simply find a way to make someone else pay. The substantive objections to having the defendant

³⁸ This, it should be noted, is equally true in the case of physical damage.

³⁹ *Supra* footnote 2 at 350, *La Forest J.* who concludes that CNR is the best insurer here. See also Siebrasse. *supra* footnote 35 at 29-30.

⁴⁰ Siebrasse, *ibid.* at 34.

⁴¹ In cases where such contractual arrangements are possible (probably not in *Norsk Steamship*) this suggests that the plaintiff deliberately, and presumably efficiently, decided to bear the risk itself. For the reasons given in the defective structure example earlier, the courts might be prudent to respect such choices by rational commercial actors.

⁴² One of the first expositions of this argument was by Rizzo, *supra* footnote 22. One must assume that the cost of negotiating such agreements will not exceed the savings in loss shifting according to the agreement, and assume that there will be no change in the number of inflated claims.

pay for this loss; indeed, the substantive reasons to prefer that CNR itself bear this loss, remain. Therefore, we do not agree with La Forest J. that such channelling ought to be encouraged, nor with McLachlan J.'s idea that special protection ought to be extended to parties who cannot channel. We do, however, agree with La Forest J. that one ought to be hesitant to extend recovery to a party that has deliberately refused to avail itself of the channelling opportunity the law does provide.⁴³

IV. Conclusion

The economic analysis suggests that in a perfect world the law would best deter social waste by imposing liability for negligently inflicted social loss. If prospective tortfeasors need not take the full cost of the social waste into account, their conduct will inflict wasteful losses. Alternatively, if they face the prospect of liability for more than the social cost of their conduct, useful activity will be deterred and services will be unavailable to buyers who are willing to pay the true costs. Liability for the lesser of the cost of repair, replacement, or market value of damaged property is consistent with this goal. Full liability for the owner's consequential economic loss is not, because much of such loss is not a true social loss at all. For the same reason liability for all foreseeable relational economic loss would promote over-deterrence, and unlike consequential claims, generate significant new administrative costs.

A case-by-case attempt to identify only true social losses for compensation, aside from appearing quite foreign to lawyers, would be too unpredictable and expensive. A rule such as the English one precluding all relational claims may provide too little deterrence because it precludes claims for relational losses that do constitute social losses. This may be roughly offset by the over-deterrence from consequential loss awards and the lower administrative costs. The La Forest J. type compromise that attempts to isolate categories of relational claims that are true social losses is a step in the right direction, assuming the benefits are worth the costs of developing and applying the exceptions. In particular, it is necessary that these exceptions are few and clear or else the administrative costs of shifting the loss from numerous plaintiffs to a single defendant will overwhelm any social benefit of doing so.

In our opinion, courts should not consider allowing claims for relational loss unless two conditions are met: the claim is for social loss, and the number of potential plaintiffs can be effectively limited. Even then, arguments based on justice, deterrence, and compensation rationales are far from compelling.

⁴³ *Supra* footnote 41.